Logic and Limitations to Investor Protection in PE/VC deals and transactions

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I. Introduction: Agency Costs and a case for Investor Protection

The age-old debate in corporate finance has been around use of debt or equity to finance business. However, with evolution of the market new alternative financing options have surfaced and changed the game of Corporate Finance in a big way. This alternative financing option has emerged as Private Equity and Venture Capital Funds (PE/VC). These funds are different from regular bank finance or other capital market financing options. The bank finance is in the form of contractual debt and is generally protected by a collateral or security over assets of the company and has priority claims over equity shareholders. While capital market finance is highly regulated by the market watchdog (SEBI) and disclosures are at its heart for investor protection. The private funding market is different from funding of businesses through equity shares and relies on issue of convertible securities. The equity shareholders are the 'real owners' of the company who through their voting power appoints 'managers' to carry out their board functions. They have last claims over the assets of the company owing to their superior position to act through Board of directors 'Board'.

The voting rights of the equity owners are Corporate in nature, i.e. they are granted under the Company Act 2013 and rules there under. However an exception to this is under section 43 and 47 of the Company Act 2013, via notification dated 5th June 2015,[1] which allows the Company to issue hybrid convertible securities, such as Compulsorily Convertible Preference Shares (CCPS) which has benefits of both partially corporate and at the same time is contractual in nature. Investors are better off with these convertible securities as they provide contractual protection as in case of bank's debt finance and also grants corporate control rights as given to equity shareholders. It is in the form of mezzanine funding which creates dual corporate structure. Thus such a corporate structure give rise to new agency costs between equity owners 'managers' and convertible securities holder 'investors'. The contractual reasons attributed to use of convertible securities (CCPS) may include, liquidation preference, interest dividends, and rank prior to the claims of equity shareholders. Other reasons may include availability of certain voting rights and that the convertibility of preference share to equity shares gives an investor upward sharing financial benefit available to equity shareholders.[2]

[1] MCA exemption notification dated June 5, 2020, <https://www.mca.gov.in/Ministry/pdf/Exemptions_to_private_companies_05062015.pdf>
[2] Joseph L Jr Lemon, 'Don't Let Me down (Round): Avoiding Illusory Terms in Venture Capital Financing in the Post-Internet Bubble Era' (2003) 39 Tex J Bus L 1 pp. 5-6

The Founders or managers are optimistic about their businesses and this exuberance leads to predicting future extreme valuations and greater future cash flows.[3] Despite distorted corporate structure and valuation gaps the rise of this market could be attributed to investors to in-depth and strategic knowledge in businesses, greater risk taking capacity, sophisticated market access, better employment of capital and many others.[4] But this does not obliterate information asymmetry between investors and managers and agency costs arising from them. Managers have greater knowledge about the company therefore there is a greater chance of 'manager's opportunism'. That is there is a strong force that the mangers will tend to maximize personal benefits at the cost of investors' money.[5]

To overcome these information barriers and protect their investments there are two types of protection accorded to the PE/VC's investors, corporate protection through 'control rights' and economic protections 'contractual covenants'. The corporate protection rights such as appointment of nominee directors, board observers, anti-dilution, affirmative voting rights give investors a hold 'control' rights over some of the management and affairs of the company. While contractual covenants such as redemption rights, freeze outs, restriction on transfers, liquidation preference seek to protect their economic interests. Both the corporate protection clauses and the economic protection clauses in a PE/VC contract serve as an important tool to check managerial opportunism at the cost of investor's money and interests.

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II. Corporate Protections 'Control Rights'

The general corporate law provides for appointment of the Board by equity shareholders and the board owes fiduciary duties towards the company and its shareholders. Some commentators have argued that the Board control through preference shareholders leads to unusual corporate governance structure and could also lead to preferred shareholder opportunism.[6] But preference shareholder's opportunism would only exist when they have absolute control over board. Since the preferred shareholder's directors do not owe any fiduciary duties towards equity shareholders[7] and could force companies to premature liquidation events, dissolution or mergers.[8] Similarly it could also be counter argued that the Board does not owe any fiduciary duties to preference shareholders. Thus, these two classes of shareholders could hurt the overall shareholder's value, which leads to additional agency costs in functioning of the company. While the Companies Act 2013, describes director's duties to be carried"...in good faith in order

[3] Victor Fleischer, 'The Rational Exuberance of Structuring Venture Capital Start-ups' (2003) 57 Tax L Rev 137

[4] Arpan Sheth, Sriwatsan Krishnan and Samyukktha T, 'India Venture Capital Report 2020', Bain & Company, March 02, 2020, < https://www.bain.com/insights/india-venture-capital-report-2020/>

[5] George G. Triantis,' Financial Contract Design in the World of Venture Capital', 68 U. CHI. L. REV. 305,

[6] Jesse M Fried and Mira Ganor, 'Agency Costs of Venture Capitalist Control in Startups' (2006) 81 NYU L Rev 967

[7] It is one of the controversial aspects of the Company law, since Shareholder's Agreement (SHA) generally provide for separate powers to appoint /removal of separate group of directors, i.e. equity shareholder's directors and investor's directors. See, Juliet P. Kostritsky, 'One Size Does Not Fit All: A Contextual Approach to Fiduciary Duties Owed to Preferred Stockholder from Venture Capital to Public Preferred to Family Business', (2017-18)70 Rutges U.L . Rev. 43

[8] Manuel A Utset, 'Reciprocal Fairness, Strategic Behavior and Venture Survival: A Theory of Venture Capital-Financed Firms' (2002) 2002 Wis L Rev 45

to promote objects of the company for the benefit of its members as a whole, and in the best interest of the company, its employees, the shareholders..".[9] Thus there might be competing interests amongst the different class of shareholders (preference and equity), with high degree on subjectivity on the 'best interest' of the company. Investor protection is achieved through ex-ante careful negotiation; it does not make any sense for equity shareholders to provide added fiduciary protection to preference shareholders.[10] However law would not also favor to let the contractually negotiated investor suffer from founder's or manager's opportunism in a company. It could be best considered as a tradeoff between risks taken by the PE/VC's on their investments and control rights granted to them. There is a strong economic argument to let the Board be controlled by common shareholders as they are the residual claimants in assets of the company.[11] The use of preference as financing generates incentives for the Founder's to enhance enterprise value and board rights enables investors to monitor the performance.

One of the best tools to overcome or minimize the agency cost and information barrier problem is use of anti-dilution clause in the financing contracts; it is the most important yet least understood commercial clause. The anti-dilution theory divides the concept in two forms; dilution of control 'percentage dilution' over the company and dilution of investment 'economic value'.[12] The convertible securities (or CCPS) are generally in form of debt and are convertible in equity shares calculated by dividing initial purchase price (plus accrued interest to such security or dividends; if any) by a fixed conversion price. If nothing otherwise is provided in the contract, an increase in number of outstanding equity shares or decrease in value of such shares, decreases 'dilute' the value of conversion right. [13] Percentage dilution occurs by issuance of new equity shares or convertible securities. This dilution is not investor's primary concern as they can protect themselves by having negative covenant restricting further issuance of securities without prior consent of investors. Alternatively or additionally they can also bargain for pre-emptive rights clause in the contract. Such a right gives an option to buy newly issued securities in order to maintain their proportionate percentage holding 'ownership' in the company.

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Pre-emptive right is in form of option and there is no obligation, i.e. an investor can subscribe to securities if they are optimistic about the company's future and wants to hold their current shareholding percentage in the company. The percentage dilution assumes all the more important role in deals wherein there is 'minimum threshold' shareholding requirement for the investors to exercise other parallel rights (Affirmative Voting or veto on restrictive matters, Right to vote at shareholders and Board meetings, Power to appoint director/Board observer, preemptive, rofo, rofr and etc) granted to them. That is there shareholding shall not fall below the prescribed minimum threshold. It is pertinent to note that mere percentage dilution do not leads to economic dilution; however an event of economic dilution can lead to percentage

[9] Section 166(2) Company Act 2013
[10] Kostritsky, n (7)
[11] Reinier Kraakman, John Armour, Paul Davies, Luca Enriques, Henry Hansmann, Gerard Hertig, Klaus Hopt, Hideki Kanda, Mariana Pargendler, Wolf-Georg Ringe, and Edward Rock, *'Anatomy of Corporate Law',* (20017 2nd Ed.) OUP; Chapter 2
[12] Michael A Woronoff and Jonathan A Rosen, 'Understanding Anti-Dilution Provisions in Convertible Securities' (2005) 74 Fordham L Rev 129
[13] ibid. p. 133

dilution as well. Thus, the primary purpose of an investor of incorporating anti dilution clause in the contracts is to protect them from economic dilution.

Economic dilution could broadly be categorized in two parts; dilution from 'initial investment' and dilution from 'current value'. Let's say; Case 1: A subscribed 1000 equity share for Rs 100/- per share in a company XYZ 'initial investment'. B subscribes 1000 equity shares for Rs 75/- per share where fair market value (fmv) is Rs. 75 per share.

A experiences an economic dilution from its initial investment (1000 x 100) which is now worth (1000 x 75). But there is no dilution from current investment. Case: 2 However, if B pays Rs 100/- per share where the fair market value of equity shares is Rs 300/- per share, A does not experience economic dilution from initial investment but undertakes economic dilution from current investment.

It is noticed from Case 1, where the fair market value decreases to Rs 75/- per share, there is a decrease in value of A's investment in XYZ. Such decrease in fmv could be due to inefficient management, business losses or otherwise, while issuance of shares to B merely evidences such decrease. This is important as for purpose of conversion price formula discussed below. And for the purpose of Case 2 wherein equity shares are issued below the fair market value investors are protected under corporate law from such dilution. The Company law prohibits the company to issue shares at discount.

A unique situation surfaces where convertible securities (CCPS, warrants, ESOPS, other convertible debts and etc) are issued. Dilution could happen by a decrease in value of convertible security itself 'full economic value' or by decrease in the net value of securities receivable upon conversion 'immediate exercise value'. The typical 'dilution event' could be by way of; dividends, share splits, extraordinary distribution of assets (cash or property), mergers and consolidations, issuance of additional securities (equity, preference, ESOPS, warrants and etc), buybacks and recapitalisation. It is observed that the standard anti-dilution formula for conversion price works well for dividend, mergers, consolidation and share split split. However, is not that effective in case of buybacks, extraordinary distribution of asset, recapitalisation and issue of warrants, ESOPS or other convertible securities.[14]

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For standard anti-dilution clause usually provide for number of equity shares convertible upon exercise will be adjusted such that convertible right holder would have obtained same number of equity shares prior to the dilutive event. Thus this ensures that immediate exercise value before and after dilutive event remains constant. For mergers and consolidation the standard anti-dilution clause provide economic value protection to the investors, only up to the extent protection afforded to equity shareholders of the target company. It is very much dependent on structure of transaction, for instance a deal wherein Board board enters into a bad merger deal (where price paid by the acquirer in form of cash, security is not adequate) or transaction is otherwise unsuccessful (break up fees), both convertible right holder and equity shareholder tend to lose value from such transaction. There is dilution of immediate exercise price as well as full economic value.

[14] Stephen I Glover, 'Solving Dilution Problems' (1995) 51 Bus Law 1241 pp 1260-302

It is pertinent to note that the managers 'Board' of the company have right to enter mergers or consolidation contracts initially, the shareholders (equity or preference) approval is required at the later stage. Further standard anti-dilution clause could only protect immediate exercise value, but does not address the problem of full economic value which includes other variables such as share price variance, default risk (default risk of merged or demerged entity is different from predecessor company). There is a strong argument in support of using sophisticated Black-Scholes or binomial option pricing model, as they reflect the full economic dilution of the convertible security.[15] However these models are complex and need external professional advice to understand, lawyers and drafters are ill-equipped to reflect these clauses in contracts with precise meaning. Hence there is a trade off between using simplistic immediate exercise value over more complicated Black-Scholes or Binomial option pricing model. The market does not even use immediate exercise price approach either, since it considers current market value as the starting point, which is irrelevant as there are information barriers over immediate exercise value and hence distorted (low) valuations situation could occur.[16]

Thus a conversion formula of anti-dilution protection is relevant as it protects the investors against economic dilution from initial investment.[17] The typical investor financing is undertaken through series and rounds of investment therefore the two standard contractual protections available are 'full-ratchet protection' and 'weighted average approach'. The latter is preferred over former as full ratchet provides complete protection from valuation gap and shifts the cost completely on equity shareholders. It does not into consideration the issue size, whereas weighted average takes into consideration the issue size of the new security which is issued at price lower than initial investment.[18] Parties to the transaction understand that some information and valuation gaps do exist and hence weighted average approach is preferable over full ratchet subject to investment and risk taken by the investors. Weighted average method it is not that harsh on equity shareholders and does not lead to their substantial dilution.

The preference shares issued to the investors are cumulative, i.e. first dividends are paid to the preference holders before any payment is made to the equity shareholder. But there is no model which protects investors from opportunistic behaviour of managers comprehensively from all the dilution events. This explains the logic of corporate protection to investors where thrust of the negotiation argues for preference shareholders to have a veto (affirmative vote) on range of dilutive events. That is they would have right to impede any Board decision which would dilute their percentage or economic right. This could give an investor to bargain or negotiate their position ex-ante such merger or consolidation transaction, wherein investors could also bargain their contractual rights such as anti-dilutive protection in merged or demerged entity. And can impede other dilutive events by imposing limits or having a Board control on managerial compensation, dividends and parting with substantial assets, buybacks and other

[15] ibid; also see, Woronoff et. al n (12) above
[16] Woronoff et. al n (12)
[17] David A. Broadwin, 'An Introduction to Antidilution Provisions (Part 1)',(June, 2004) Prac. Law.,
[18] Edwin L. Miller, Jr. et al., 'Venture Capital Financings of Technology Companies',(2002) 1 Internet Law and Practice

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form of distribution of capital. Further full-economic value protection could be compensated by debating or resolving in Board meetings such investor dilutive conflicts.

III. Contractual Covenants and Economic Protections

The above part explained the limits and logic of bargaining Board control rights for investor protection. The other economic protection of investor's interest needs a contractual determination upfront. This leads us to the circular debate of extending fiduciary duties protection to preference shareholders.[19] The exit structure, liquidation preference and other rights play a crucial right for investors to liquidate their investments and generate return.

The private companies have no market for their shares. The managers receive compensation from the cash flows of the company while investors barely have any rights over such revenues. Investors more often face a state of limbo, a phase where no return on investment is received. The exit structure, for investors play as significant contractual role in PE/VC deals and finance. Exit may be achieved by initial public offering (IPO) and demand listing of shares or acquisition of the portfolio company, redemption of investment 'put right' or liquidation of the company. The other board control corporate rights which have been discussed above are important and other contractual covenants are to be understood in tandem to protect investor's interest from manager's opportunism.

These rights may differ from stage of the company, as in initial stage the investors are less concerned about initiating exit but focuses on protecting exit being enforced on them. This explains the logic of promoter lock-in for initial period of business since investors have no interest in managing the affairs of the company. However, in later stages of life cycle of the company they are keener to exit and liquidate returns on their investments.[20] There always remain a trade-off between the control rights and the liquidity of the investment, depending on aim of investors and negotiations with company. Since investor having early exit option would have less incentive to monitor the company.[21] In PE/VC investor hardly have contractual right to liquidate their investments.[22] It is argued that the typical companies receiving PE/VC funding are typical technology companies and hence they do not hold substantial assets. Therefore, dissolution of the firm even though having a liquidation preference does not serve the end goal of generating added returns.

The two rights which protect them are 'liquidation preference', right to receive usually (1x, 2x, etc.) amount to their original investment and 'participation right' in any distributions after liquidation preference. Another potent contractual exit option is by way of redemption rights (mandatory, optional 'put', optional company redemption 'call'). Mandatory redemptions pose a challenge, as such provision might dissuade future investors, over the fear their capital might

[19] Kostritsky, n (7)
[20] D Gordon Smith, 'The Exit Structure of Venture Capital' (2005) 53 UCLA L Rev 315
[21] ibid.
[22] Investors may force the company to liquidate or force the Board to accept liquidation or face breach of fiduciary duties; See, William W. Bratton, 'Gaming Delaware', (2004) 40 Willamette L. REV. 853.

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be used for redemption purposes. The put option granted to investors is more flexible and acts as a double edge sword. It gives investor certain leverage over management as investor could exercise such rights when there is a dispute or management opportunism or the company might not be generating expected return.[23] The call option on the contrary gives such right to the company to initiate force exit of investors when the company is doing well.

Other exit options are conversion which could be optional or on occurrence of an event such as IPO or acquisition. The timing of IPO could be negotiated in Board meeting or veto right could be bargained during investment. While the domestic laws, policies and capital market efficiency are essential for PE/VC industry and market.[24] But the company's future growth and earnings prospects are scrutinised and put to test when they go public. For the purpose of acquisition and IPO investors only benefits if price offered or received for the security is greater than the liquidation preference. The cases where company is in limbo phase, where there is no possibility of an IPO or other potent exit option for investors, further they do not even have recourse to claim tax benefit and book losses where company shares have become worthless.[25] This explains the rationale for the bargaining rights of liquidation preference and redemption rights demanded by investors which compensates illiquidity of their investments.

The investor in later stages of company may cash out via sale of company, but it could be blocked by mangers owing to their over enthusiasm on prospects of company or potential job loss. Investors could reserve right of first refusal 'ROFR', if managers deem an offer inadequate, they should acquire investor's shares at the same offered price. Counter intuitively transactions where acquisitions or sale is initiated by mangers where investors do not any power to veto such transaction. Investors could demand a take me along clause 'tag right', which protects minority investors and let them exchange their securities on the same terms as offered to managers. There might be added cost for investors to run and manage the affairs of the company if the manager's engages in anti-competitive activities or exist the company abruptly. Other contractual protections to overcome managerial agency costs; promoter lock-in, limited use of proprietary information of company, restriction on transfer of shares to competitors, restriction on working outside of company 'moon lighting'.[26]

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IV. Conclusion

[23] Exit rights decreases investors willingness to compromise, See, Annaleena Parhankangas, Hans Landstrorm, D. Gordon Smith, 'Experience, Contractual Covenants and Venture Capitalists' Responses to Unmet Expectations', (2005) 7 Routledge – 4 pp. 297-318

[24] Lin Lin, 'Venture Capital Exits and the Structure of Stock Markets in China', (2017) CUP Vol. 12, Issue 1

[25] George W. Dent Jr., 'Venture Capital and the Future of Corporate Finance', (1992) 70 Washington University L Rev 4

[26] ibid pp 1057-58

The investor protection lies at the core of development of PE/VC markets. These markets are highly risky and there exist information barriers and agency costs to transactions. A right balance should be achieved between investor protection and incentives of founders to maximize enterprise value. Some commentators argue that the investor clauses put on draconian conditions on mangers or founders and forces mangers to bubble the valuations of the company.[27] A balancing nature in PE/ VC deals could be achieved, as the company receives premium for selling their control rights, target based compensation for managers, while managers even bargains for call rights, right of first offer (ROFO) rights where investors sell their securities to third parties. They often bargain for 'drag right' which can force minority shareholders (investors) to sell to overcome the situation of minority freeze outs in deals. The investor's primary incentive is to generate good returns on their investee company's therefore anti-dilution protection and predetermined exit options along with liquidation preference form core starting point to any PE/VC deal or transaction.

[27] Joseph L Jr Lemon, 'Don't Let Me down (Round): Avoiding Illusory Terms in Venture Capital Financing in the Post-Internet Bubble Era' (2003) 39 Tex J Bus L 1